



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

Number: **201204018**
Release Date: 1/27/2012

Date: November 1, 2011

Contact Person:

Identification Number:

Contact Number:

Employer Identification Number:

Form Required To Be Filed:

Tax Years:

UIL: 501.07-00; 501.07-01; 501.07-02; 501.07-03;
501.07-05; 501.04-00

Dear :

This is our final determination that you do not qualify for exemption from federal income tax as an organization described in Internal Revenue Code section 501(c)(7). Recently, we sent you a letter in response to your application that proposed an adverse determination. The letter explained the facts, law and rationale, and gave you 30 days to file a protest. Since we did not receive a protest within the requisite 30 days, the proposed adverse determination is now final.

You must file federal income tax returns on the form and for the years listed above within 30 days of this letter, unless you request an extension of time to file.

We will make this letter and our proposed adverse determination letter available for public inspection under Code section 6110, after deleting certain identifying information. Please read the enclosed Notice 437, *Notice of Intention to Disclose*, and review the two attached letters that show our proposed deletions. If you disagree with our proposed deletions, you should follow the instructions in Notice 437. If you agree with our deletions, you do not need to take any further action.

If you have any questions about this letter, please contact the person whose name and telephone number are shown in the heading of this letter. If you have any questions about your federal income tax status and responsibilities, please contact IRS Customer Service at

Letter 4040 (CG) (11-2005)
Catalog Number 47635Z

1-800-829-1040 or the IRS Customer Service number for businesses, 1-800-829-4933. The IRS Customer Service number for people with hearing impairments is 1-800-829-4059.

Sincerely,

Lois G. Lerner
Director, Exempt Organizations

Enclosure
Notice 437
Redacted Proposed Adverse Determination Letter
Redacted Final Adverse Determination Letter

Letter 4040 (CG) (11-2005)
Catalog Number 47635Z



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Date: September 13, 2011

Contact Person:

Identification Number:

Contact Number:

FAX Number:

Employer Identification Number:

LEGEND:

B = individual
C = individual
D = business
F = individual
G = individual
N = business
O = state
P = city
Q = date
R = date
s = dollar amount
T = date
U = number
V = number

UIL:

501.07-00
501.07-01
501.07-02
501.07-03
501.07-05
501.04-00

Dear _____ :

We have considered your application for recognition of exemption from federal income tax under Internal Revenue Code section 501(a). Based on the information provided, we have concluded that you do not qualify for exemption under Code section 501(c)(7). The basis for our conclusion is set forth below.

Letter 4034 (CG) (11-2005)
Catalog Number 47628K

Issue

Do you qualify for exemption from federal income tax under section 501(c)(7) of the Internal Revenue Code? No, for the reasons stated below.

Alternate Issue

Do you qualify for exemption from federal income tax under section 501(c)(4) of the Internal Revenue Code. No for the reasons stated below.

Facts

You were incorporated in O on Q. You were organized as a mutual benefit Corporation primarily for social and educational purposes. More specifically, you limited your purposes as follows:

- a. To establish, maintain and conduct a club for the social enjoyment, pleasure and recreation of the members.
- b. To encourage and promote interest in understanding the importance of the civil liberties enjoyed by all Americans, regardless of their creed, ethnic, religious or social heritage.
- c. To further the education of its members regarding the historical background of the development and growth of civil liberties in the United States.
- d. To perpetuate the above purposes in the event of dissolution by distributing any and all assets to a successor organization or public charity.
- e. To promote participation of its members in the processes of local, state and federal legislative bodies.

You explained that members of the general public often refer to you as N restaurant. You further explained that N was a restaurant owned and operated by D, a for profit owned in part by B and C. N ceased to exist on R, two days after you were formed. You utilize the facility previously occupied by N. You have entered into a lease agreement with D for the use of the that facility and are obligated to pay rent to D in the amount of s dollars per month.

You are governed by two board members, B and C. B, your president, executed the lease agreement with D on your behalf and then subsequently executed an addendum

to the lease agreement on behalf of D. C, your vice-president and treasurer, executed the addendum to the lease agreement with D on your behalf and executed both the lease and addendum thereto, on behalf of D.

You explained in your application and responses submitted to our requests for additional information that you conduct the following activities:

- a. You operate a dining room seven days a week from 6:00 a.m. to 2:00 p.m. at N, where you sell various food items. Anyone paying your one dollar annual membership fee may purchase food at your restaurant. From May until September, the dining room is also open on the fourth Friday of the month from 5:00 p.m. to 8:00 p.m.
- b. You distribute newsletters to your members that include stories and anecdotes, which are intended to educate your members about American history and their civil liberties.
- c. You make your dining room available to local not-for-profit groups twice a month without charge. In addition, the non-for-profit groups are not obligated to purchase food from your dining room. Further, you donate ten percent of the income received on the night your facility is utilized by a not-for-profit group to the featured not-for-profit group.
- d. You conduct monthly meetings regarding civil liberties including lectures from local political candidates and college professors.

You have two classes of membership, namely, equity membership and social membership. You defined equity membership as "one who has contributed cash or other property to the club (other than dues or periodic assessments) and have (sic) the right to elect the board of directors". You further explained that B and C are equity members. In addition, you explained that upon dissolution your assets would be "first used to pay off any liabilities of the club, and then to pay back the amount of contributions paid in by equity members. Remaining assets are then to be distributed to the membership at large."

You defined a social member as "one who is current with annual dues and any other assessment, and is entitled to participate in the social activities of the club." You explained that one becomes a member by paying one dollar annually. In return, the member receives a membership card. Membership is open to anyone at least eighteen years of age and interested in learning about civil liberties. You encourage membership in by distributing copies of your newsletters. Membership is terminated when a member

fails pay required annual dues. You further explained that the number of your members changes daily. At last count, on T, you had U members. The maximum capacity of your facility is V people.

The newsletters submitted with your application indicated that you have been issued four citations from the City of P, O for violations of a city ordinance, which banned smoking in restaurants. Your response to our questions regarding the status of these citations was as follows: "The issues have been completely resolved. The City of P rescinded or withdrew the citations. The main issues involving the smoking ban ordinance were its coverage, application and enforcement. Since then, the City of P has banned smoking from all bars, private clubs and businesses."

Your newsletters include various quotes from early Americans, but primarily have information regarding your menu and the operation of your dining room and even solicit suggestions for new menu items. Your newsletters state that local officials encouraged groups supporting the smoking ban in your community to come to your club without joining as a member. They instruct your members to be on the lookout for non-members who support the smoking ban and have not joined your club. You stated that these persons would be trespassing and are not welcome at your club. Your newsletters also advertise the location of your club as N restaurant.

You are supported primarily by income received through the operation of your dining room. You report this income in your application as income from unrelated business activities and have reported this income on Tax Form 990-T. Your expenses are mainly operational including salaries to F and G, the daughter and son-in-law of B and C, your equity members. A review of past years also shows expenses for food and drink, supplies, employee wages, advertising, taxes and utilities comprising the majority of expenditures.

Section 501(c)(7) Law

Treasury Regulation 1.501(c)(7)-1 provides as follows:

(a) The exemption provided by section 501(c)(7) applies only to clubs which are organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes, but does not apply to any club if any part of its net earnings inures to the benefit of any private shareholder. In general, this exemption extends to social and recreation clubs which are supported solely by membership fees, dues, and assessments. However, a club otherwise entitled to exemption will not be disqualified because it raises revenue from members through the use of club facilities or in connection with club activities.

(b) A club which engages in business, such as making its social and recreational facilities available to the general public or by selling real estate, timber, or other products, is not organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes, and is not exempt under section 501(a) [26 USCS § 501(a)]. Solicitation by advertisement or otherwise for public patronage of its facilities is prima facie evidence that the club is engaging in business and is not being operated exclusively for pleasure, recreation, or social purposes. However, an incidental sale of property will not deprive a club of its exemption.

Rev. Rul. 58-588, 1958-2 C.B. 265, held that a social club that sells an unlimited number of memberships to so-called "members", who have no voice in the management of the club and whose only rights are to use the club's facilities upon payment of specified fees, is not a tax-exempt social club within the meaning of section 501(c)(7) of the Internal Revenue Code. Income from the members was, in reality, income from the general public.

The organization described in Rev. Rul. 58-588, 1958-2 C.B. 265, had two classes of membership, namely active and associate members. The active members controlled all business decisions of the organization and some of the active members were employees of the organization. The ruling held that the organization was operated in the personal interest of a few individuals; that social features are not a material purpose of the club but are subordinate and merely incidental to the active furtherance of a predominant purpose to engage in the business of selling services for profit to an unlimited number of individuals termed "associate members;" that "associate" membership is not a true membership but is merely a guise under which virtually unlimited numbers of individuals may utilize the club facilities; and that income from associate members is in reality income from transactions with the general public

Rev. Rul. 58-589, 1958-2 C.B. 266, sets forth the criteria for determining whether an organization qualifies for tax-exempt status per Internal Revenue Code section 501(c)(7). This revenue ruling clearly states that an organization that makes its social and recreational facilities available for use by the general public is engaged in a business and is not exempt under Internal Revenue Code section 501(a). Further, solicitation by advertisement of public patronage of a social club's facilities will have an adverse effect on its tax exempt status. In addition, this ruling provides that a commingling of the members must play a material part in the life of the organization.

Rev. Rul. 69-635, 1969-2, C.B. 126, held that an organization was not exempt under section 501(c)(7) of the Internal Revenue Code because the organization was designed to provide services to its members and there was no significant commingling of members.

Public Law 94-568, provides that organizations exempt under section 501(c)(7) may receive up to 35 percent of their gross receipts, including investment income, from sources outside of their membership without losing their tax-exempt status. It is also intended that within this 35-percent amount not more than 15 percent of the gross receipts should be derived from the use of a social club's facilities or services by the general public.

In Chattanooga Automobile Club v. Commissioner, Warren Automobile Club, Inc. v. Commissioner, 182 F. 2d 551 (6th Cir. 1950), the United States Court of Appeals 6th Circuit held that to be exempt under the Act of Congress, a club must have been organized and operated exclusively for pleasure, recreation, and other non-profitable purposes. The court further specified that the words "other non-profitable purposes" must be construed as coming within the same classification as pleasure and recreation. In addition, there must be at least some sort of commingling of members to constitute a club. The court held that the two automobile clubs petitioning the court were not exempt under section 101(9) of the Internal Revenue Code of 1939 as a social club because the members of these clubs did not commingle.

In Keystone Automobile Club v. Commissioner, 181 F. 2d 402 (3rd Cir. 1950), the United States Court of Appeals 3rd Circuit defined the word "club" to include some type of mingling of people together as well as a common object. In this case, the court held that the Keystone Automobile Club was not exempt under section 101(9) of the Code for a number of reasons one of which was because they saw no evidence of the commingling of members.

Section 501(c)(4) Law

Treasury Regulation 1.501(c)(4)-1 provides in pertinent part as follows:

(a) Civic organizations--(1) In general. A civic league or organization may be exempt as an organization described in section 501(c)(4) [26 USCS § 501(c)(4)] if--

(i) It is not organized or operated for profit; and

(ii) It is operated exclusively for the promotion of social welfare.

(2) Promotion of social welfare--(i) In general. An organization is operated exclusively for the promotion of social welfare if it is primarily engaged in promoting in some way the common good and general welfare of the people of the community. An organization embraced within this section is one which is operated primarily for the purpose of bringing about civic betterments and social improvements. A social welfare organization

will qualify for exemption as a charitable organization if it falls within the definition of charitable set forth in paragraph (d)(2) of § 1.501(c)(3)-1 and is not an action organization as set forth in paragraph (c)(3) of § 1.501(c)(3)-1.

(ii) Political or social activities. The promotion of social welfare does not include direct or indirect participation or intervention in political campaigns on behalf of or in opposition to any candidate for public office. Nor is an organization operated primarily for the promotion of social welfare if its primary activity is operating a social club for the benefit, pleasure, or recreation of its members, or is carrying on a business with the general public in a manner similar to organizations which are operated for profit.

Rev. Rul. 68-46, 1968-1 C.B. 260 A war veterans' organization did not qualify for exemption from federal income tax under I.R.C. § 501(c)(4) because it was primarily engaged in renting a commercial building and operating a public banquet and meeting hall having bar and dining facilities.

Application of 501(c)(7) Law

Not operated for pleasure, recreation or other non-profit purpose

An organization cannot be recognized as exempt under section 501(c)(7) unless it shows that it is both organized and operated substantially for pleasure, recreation or other non-profitable purpose. Although your Articles of Incorporation indicate that you are organized for the purposes prescribed by section 501(c)(7) of the Code, your activities indicate that you are not substantially operated for these purposes. Rather, you are formed primarily to operate a restaurant. Your primary activity is operating a dining room, where anyone paying your one dollar annual membership dues can purchase food. In the original financial data submitted with your application, you included receipts from your dining room as unrelated business income and previously filed unrelated business income tax returns for this income acknowledging that this income was not derived from an exempt activity. Further, you were formed two days before N restaurant dissolved. You are operated by the same people who owned N restaurant and these former owners are your equity members. Your newsletters advertise the location on your club as N restaurant. In addition, your newsletter describes your menu, hours of operation and solicits menu suggestions from your patrons. Your newsletters further communicate information about citations issued to you by the city of P for violating a smoking ban and you encouraged your members to be on the lookout for people patronizing your dining room who may support the smoking ban. You explained that the smoking ban citations have been resolved because the smoking ban now applies to all bars, private clubs and businesses. You explained that your initial issue with the smoking ban was its coverage. Based on these facts, it appears that you have been formed to circumnavigate or avoid compliance with the original smoking ban ordinance issued by the City of P.

You explained that you solicit new members, and thus patrons of your dining room, by distributing copies of your newsletter. According to Treasury Regulation 1.501(c)(7)-1 and Rev. Rul. 58-589, soliciting public patronage by advertisement or other means is prima facie evidence that a club is engaging in business and is not operated exclusively for pleasure, recreation or social purposes. Because you solicit an unlimited number of members for your dining room by distributing newsletters, you are not operated exclusively for pleasure, recreation or social purposes.

Regulation 1.501(c)(7)-1 further provides that a club which engages in business, such as making its social and recreational facilities available to the general public or by selling real estate, timber, or other products, is not organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes, and is not exempt under section 501(a) [26 USCS § 501(a)]. Because you sell food to the general public through your issuance of unlimited memberships, you are not organized exclusively for pleasure, recreation and other nonprofitable purposes as required by Treasury Regulation 1.501(c)(7)-1 and section 501(c)(7) of the Code.

Transacting business with the general public, lack membership requirements

Similar to the organization described in Rev. Rul. 58-588, you sell an unlimited amount of memberships demonstrated by the fact that your membership changes daily. Although you explained that potential members should be eighteen and have an interest in civil liberties, anyone who pays your one dollar annual membership may join your club. Although your facility has the capacity to accommodate only V persons at a time, you continue to add members daily. At your last count, your members exceeded 5000 people.

Also similar to the organization described in Rev. Rul. 58-588, you have two classes of members. Your two equity members make all of your decisions. In addition, like the organization described in Rev. Rul. 58-588, you employ family members of the two equity members. Your social members do not exercise any control over you and do not have a voice in the management of the club since the board of directors is selected by the two equity members. The only rights accorded social members are the rights to purchase food in the dining room and to participate in the few social activities you conduct. Because your members do not exercise control over you, you do not have a valid membership and are only conducting business with the general public.

Private interests of your equity members and their family

As previously described, you were formed two days prior to the dissolution of N and are operated by the former owners of N, equity members B and C, who make all of your business decisions. Upon your dissolution your assets, after payment of debts, will be used to pay back contributions made to you by your equity members. Further, your

equity members entered into a lease agreement in which they signed as both lessors and lessees. Your equity members are receiving lease payments as owners of the facility. In addition, you pay salaries to the equity members' son and daughter-in-law. All the financial transactions are decided by your equity members. There is no oversight or outside control to ensure that these transactions are made at arms length or in your best interest as opposed to the best interest of your equity members. Accordingly, you are operated for the personal interests of your equity members. Section 501(c)(7) of the Code provides that no part of net earnings shall inure to the benefit of any private shareholder. Since your income inures to your equity members and their family via return of capital contributions, lease payments and salaries, you do not qualify for exemption under section 501(c)(7) of the Code.

Lack of social activities or commingling among your members

To be operated for the purposes described in section 501(c)(7) of the code, an organization must have an established membership of individuals who meet to make personal contacts and promote fellowship. The commingling of the members must play a material part in the life of a tax exempt social club as required by Rev. Rul. 58-589 and 69-635, *supra*. Organizations failing to meet this commingling requirement have been denied exemption, Chattanooga Automobile Club v. Commissioner, Warren Automobile Club, Inc. v. Commissioner, *supra*, and Keystone Automobile Club v. Commissioner, *supra*. At last count, you had U members, yet your facility can only accommodate V people. This is direct evidence that members cannot be regularly comingling as your facility cannot physically accommodate their being in the same location. There is no common interest among your members and your social activities are only incidental to your overall activities. You conduct social activities only once a month, while your dining room remains open seven days a week. Because you do not have a facility to accommodate all of your members and your social meetings are a relatively small part of your total activities, commingling is not a material part of the life of your club. Like the organization described in Rev. Rul. 69-635, *supra*, you are primarily providing services. By operating a dining room you are providing services and do not have significant commingling among your members.

You receive more than thirty-five percent of your income from outside a valid membership.

Because your transactions with social members are actually transactions with the general public, for the reasons described above, you do not receive at least 65% of your income from members as required by Public Law 94-568. Further, you have reported all of the income from your dining room as unrelated business income rather than income from members. Accordingly, you do not meet the income requirements for organizations exempt under section 501(c)(7) of the Code.

Application of 501(c)(4) Law:

You are not operated primarily for the promotion of social welfare, and otherwise fail to qualify under section 501(c)(4) of the Code.

Although you distribute newsletters and hold monthly lectures, you operate your dining room seven days a week. The operation of your dining room is clearly your primary activity, similar to the organization described in Rev. Rul. 68-46 above. Thus while your newsletter and civil liberty lectures may qualify as promoting social welfare under section 501(c)(4) of the Code, you do not qualify for recognition of exemption under section 501(c)(4) of the Code because your primary activity is not promoting social welfare, but rather operating a dining room. Treasury Regulation 1.501(c)(4)-1 provides that organizations carrying on a business with the general public in a manner similar to organizations which are operated for profit are not operated primarily for the promotion of social welfare. As described in the 501(c)(7) application of law section above, your primary activity is transacting business with the general public by selling food in your dining room. Accordingly, you do not qualify for recognition of exemption from federal income tax under section

Further, the net earnings of organizations qualifying for exemption from federal income tax under section 501(c)(4) of the Code must be devoted exclusively to charitable, educational, or recreational purposes. You explained that upon your dissolution, your remaining assets will be distributed to your equity members after your liabilities are satisfied. Thus, your net earnings are not devoted exclusively to charitable, educational or recreational purposes as required by section 501(c)(4) of the Code and you do not qualify for recognition of exemption from federal income tax under section 501(c)(4) of the Code.

Conclusion

Based on the information provided we conclude that you are not operated for pleasure, recreation or other nonprofitable purposes described in section 501(c)(7) of the Internal Revenue Code. Any such activities that you engage in are merely incidental to the furtherance of your purpose of selling food to the general public. Further, you are organized for the private benefit of your equity members, and do not meet the membership, income, and commingling requirements for organizations qualifying for exemption from federal income tax under section 501(c)(7) of the Code. Accordingly, you do not qualify for recognition of exemption under section 501(c)(7) of the Internal Revenue Code.

In addition, we conclude that you are not primarily operated for the promotion of social welfare as described in section 501(c)(4) of the Code. Your primary activity is to engage in the business of selling food to the general public. Accordingly, you do not

qualify for recognition of exemption under section 501(c) (4) of the Internal Revenue Code.

You have the right to file a protest if you believe this determination is incorrect. To protest, you must submit a statement of your views and fully explain your reasoning. You must submit the statement, signed by one of your officers, within 30 days from the date of this letter.

We will consider your statement and decide if that information affects our determination. If your statement does not provide a basis to reconsider our determination, we will forward your case to our Appeals Office. You can find more information about the role of the Appeals Office in Publication 892, *Exempt Organization Appeal Procedures for Unagreed Issues*.

Types of information that should be included in your appeal can be found on page 2 of Publication 892, under the heading "Regional Office Appeal". These items include:

1. The organization's name, address, and employer identification number;
2. A statement that the organization wants to appeal the determination;
3. The date and symbols on the determination letter;
4. A statement of facts supporting the organization's position in any contested factual issue;
5. A statement outlining the law or other authority the organization is relying on; and
6. A statement as to whether a hearing is desired.

The statement of facts (item 4) must be declared true under penalties of perjury. This may be done by adding to the appeal the following signed declaration:

"Under penalties of perjury, I declare that I have examined the statement of facts presented in this appeal and in any accompanying schedules and statements and, to the best of my knowledge and belief, they are true, correct, and complete."

Your appeal will be considered incomplete without this statement.

If an organization's representative submits the appeal, a substitute declaration must be included stating that the representative prepared the appeal and accompanying documents; and whether the representative knows personally that the statements of facts contained in the appeal and accompanying documents are true and correct.

An attorney, certified public accountant, or an individual enrolled to practice before the Internal Revenue Service may represent you during the appeal process. To be represented during the appeal process, you must file a proper power of attorney, Form 2848, *Power of Attorney and Declaration of Representative*, if you have not already

done so. For more information about representation, see Publication 947, *Practice Before the IRS and Power of Attorney*. All forms and publications mentioned in this letter can be found at www.irs.gov, Forms and Publications.

If you do not intend to protest this determination, you do not need to take any further action. If we do not hear from you within 30 days, we will issue a final adverse determination letter to you. That letter will provide information about filing tax returns and other matters.

Please send your protest statement, Form 2848 and any supporting documents to the applicable address:

Mail to:

Internal Revenue Service
EO Determinations Quality Assurance
Room 7-008
P.O. Box 2508
Cincinnati, OH 45201

Deliver to:

Internal Revenue Service
EO Determinations Quality Assurance
550 Main Street, Room 7-008
Cincinnati, OH 45202

You may also fax your statement using the fax number shown in the heading of this letter. If you fax your statement, please call the person identified in the heading of this letter to confirm that he or she received your fax.

If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

Lois Lerner
Director, Exempt Organizations

Enclosure, Publication 892